



## CHAPTER 6

### SHORT-TERM FINANCE EXPORTS

#### ❖ *Objectives*

After studying this chapter you should be able to understand:

- 6.1 Short-term finance: definition, difference between post-shipment and pre-shipment, with recourse and without recourse finance
- 6.2 Definitions of factoring; types, organization of factoring, and relationships between partners in a factoring operation
- 6.3 The legal framework of factoring
- 6.4 Advantages and disadvantages of factoring
- 6.5 The factoring services in Romania

## **6.1 Short-term finance: definition, difference between post-shipment and pre-shipment, with recourse and without recourse finance**

No legal definition of *short-term finance* exists, but the British specialized literature will consider any facility, which would normally be repaid within two years to be of a short-term nature.

Facilities, which cover a two to five year period, are usually classed as medium-term facilities and any period in excess of five years is normally classed as long-term.

Usually, exporters of consumer goods require short-term finance because importers do not expect long periods of credit. Exports of capital goods are often sold on medium- or long-term credit.

*Post-shipment finance* is money required to finance the exporter between dispatch of goods and receipt of payment. Usually, this period is longer for exporters than for businesses, which sell purely in the domestic market.

*Pre-shipment finance* is the money required to finance the business between the commencement of the manufacturing process and the dispatch of goods. This period will be identical for the exporter and the non-exporter.

If *finance* is provided *with recourse* then the exporter is legally responsible for payment of that money. Hire, purchase, leasing, forfeiting and export house type facilities may be for both short- and medium-term credit periods.

If *finance* is provided *without recourse*, it means that the lender has agreed to look to someone other than the exporter for repayment.

## **6.2 Definitions of factoring; types, organization of factoring, and relationships between partners in a factoring operation**

### ***The beginnings of factoring***

The first market for factoring was in the United States of America where from the early 1890s factors started to offer their services to clients active in textile and clothing sector. Until the 1960s American companies were primarily family owned. But when banks were given the authorization to engage in factoring, a string of acquisition took place.

Today, nearly all of the major American factors are bank owned, and factoring has become more accepted and respected as an integral part of the financial sector.

As ownership of the American factors passed to the banks, factoring began to go overseas. American know-how was first introduced to the United Kingdom in the 1960s, and similar initiatives followed later in other Western European countries. Some companies were joint ventures with large American factors, while others were independent initiatives taken by local commercial banks with a keen eye for the attractiveness of receivables financing on a factoring *basis*.

Today, more than 300 factoring companies can be found in all European countries including the newly emerging markets in Central and Eastern Europe.

At a diplomatic conference in Ottawa in May 1988 the International Institute for the Unification of Private Law in Rome (commonly known as UNIDROIT) presented “...*uniform rules to provide a legal framework that will facilitate international factoring...*”. The full text of their definition contained in Article 1.2 and 1.3 is as follows:

2. *For the purposes of this Convention, **factoring contract** means a contract concluded between one party (the supplier) and another party (the factor) pursuant to which:*

(a) *The supplier may or will assign to the factor receivables arising from contracts of sale of goods made between the supplier and its customers (debtors) other than for the sale of goods bought for their personal, family or household use;*

(b) *The factor is to perform at least two of the following functions:*

*Finance for the seller, including loans and advance payments;*

*Maintenance of accounts (ledger keeping) relating to the A/R;*

*Collection of receivables;*

*Protection against default in payment by the buyers;*

(c) *Notice of the assignment of the receivables is to be given in writing to the debtors.*

3. *In this Convention references to “goods” and “sale of goods” shall include services and the supply of services.”*

This is the official definition of factoring, internationally accepted. The definition presented by the Bank of France is based on the juridical dimension:

“A factoring operation consists in the transfer of commercial receivables from their owner to a factor, which assumes the obligation to cash them in, even in the case of a temporary or permanent incapacity of the debtor. The factor can pay in advance all, or only a part of, the total amount of the transferred receivables.”

The most used definition is the British one, due to its simplicity and concision: the operation through which a company sells its ‘Clients’ accounts to a factor. This description of factoring can be translated into legal terms as the technique allowing a seller of goods or services to transfer his receivables towards a specialized institution, which becomes their owner.

A factor purchases book debt of a client company, usually buying that payable within a maximum period of 180 days. Up to 80 % of the invoice value is paid to the Client Company immediately, the remainder, net of fees and expenses, is paid after the debts have been cleared.

The implementation of factors (credit institutions) was determined by the supplier’s need to cash in the amounts from his debtors as soon as possible and to be exempted from keeping track of the debtors, or from pursuing them in case of non-payment. The factor will take on him the duty of cashing in the client’s receivables, becoming their beneficiary. At the same time, he assumes the whole risk of non-payment by the debtors<sup>1</sup>.

The main types of factoring are:

### **1) The full service**

Factoring in its full form, or old line (i.e. traditional) factoring, is a continuing relationship between a factor and a supplier (the client) of goods and services to trade customers in which the factor purchases substantially all the trade debts of his client arising from such sales of goods or the provision of such services as they arise in the normal course of business.

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<sup>1</sup> Basno,C., Dardac,N., Floricel,C., *Monedă, credit, bănci*, Ed. Didactică și pedagogică, București, 1994

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The client in return for agreed fees and finance charges is thereby relieved:

- From the need to administer and control a sales ledger and collect amounts payable from the debtors;
- From losses arising from the inability of a debtor to pay;
- From the provision of trade credit to the debtors, to a substantial degree.

The transfer of ownership of the debts is normally accompanied by the submission to the factor of the copies of invoices that represent the debts sold. In some cases, the factor may require the submission of originals to him for onward transmission to the debtors, accompanied by copies for retention by the factor. Many factors now arrange for their larger clients to notify debts to them by electronic means and some do not even insist on the input to be supported by hard copies of invoices or credit notes.

The factor, in turn, is responsible to the client for the purchase price of the debts assigned. The purchase price is normally the amount of any discount or other allowance allowed to the debtor and, in some cases, after the deduction of the factor's charges. The factor will credit the account of the client in his records with such purchase price of debts sold and as a corollary the client may charge all his sales to one account – that of the factor. The client will now look to the factor alone to collect the proceeds of his sales.

The final date for payment of the purchase price will be either a fixed number of days after invoice date (often referred to as *the maturity date*) or when collection has been effected from the debtor.

To the extent that the factor has given approval of the debts, he purchases the debts without recourse to the client as regards the debtor's failure to pay owing to insolvency. The client thus receives full protection against bad debts provided that he does not sell to any debtor not approved by the factor or to an extent greater than the approval given.

By making an early payment (sometimes referred to as *prepayment* or an *initial payment*) on account of a substantial part of the purchase price of each debt as soon as it is created and purchased, the factor provides the finance to meet the trade credit requirements of the client's debtors. Some factors make such prepayment by way of an advance secured by their right to set it off against the full purchase price when due, whereas others provide for prepayments by part payments of the purchase pieces.

The factor will make a retention of part of the purchase price of each debt so that in aggregate he will hold a sufficient balance to provide for any debt to be charged back to the client by way of recourse for the non-payment of an unapproved or disputed debt. However, the balance credited for the purchase price of debts purchased less the retention may normally be drawn by the client by way of prepayment at short notice.

## **2) Recourse factoring**

Although most forms of factoring other than the full service are provided with full recourse to the client in respect of the failure of the debtor to pay for any reason, **recourse factoring** normally describes the service by which the factor provides finance for the client and carries out the functions of sales ledger administration and collections, but does not protect the client against bad debts. The factor has full "recourse" (the right to have payment guaranteed or the debt repurchased by the client) for debts unpaid for any reason, including insolvency of the debtor.

Thus, the variation is effected by the simple expedient of providing that in respect of every debt purchased by the factor he will have the right to sell it (or part of it) back to the client for the amount for which he credited the purchase price originally in addition to his charges (or be guaranteed payment in full by the client) to the extent that the debtor shall not have settled it by an agreed period after invoice date.

The period often agreed is three months or 90 days from the end of the month in which the invoice is dated. Such a period postulates that in many trades and industries, in which the normal usage is for payment to be due at the end of the month following that of the invoice, the factor must collect payment within two months of the due date or the recourse may come into effect.

It is usual to provide that the factor will refrain from exercising his right of recourse for a specified further period in payment of an additional charge by the client. In such case, however, the factor may require that an additional retention be maintained against the purchase price of further debts purchased so that in effect the client will have repaid the amount paid by the factor against, or on account of, the purchase price of the unpaid debts.

In this way, in respect of debts that are seriously overdue, the client will remain relieved from the collection function but the finance for such debts may be withdrawn. If it becomes irrecoverable, the recourse is then finally exercised. It is apparent that the factor, in such a case, does not have the ultimate responsibility for collection. Approvals of credit are given by the factor on debtor accounts for the purpose of specifying the amount of finance available against them or as an advisory service to the client, or for both reasons.

### **3) Agency factoring**

This variant of the service is sometimes referred to as **bulk factoring** but as virtually all factoring relates to the whole of a client's sales with the submission to the factor of batches or schedules of debts in bulk, the term "bulk" could be applied to all forms.

The term "agency" is now usually used to denote the form for which the Germans use the more descriptive term "Eigen – Service Factoring" (Own-Service Factoring). This form of factoring is further removed from the full service in that the factor, although requiring disclosure to the debtors, takes no responsibility for the administration or collection of the debts and the factoring is fully on a recourse basis.

In some cases directions are given to the debtor to pay direct to the factor; in others, although notice of the assignment is given to debtors, they are instructed to pay to the client as the factor's agent. In the latter cases the client is obliged to hold the money recovered in trust for the factor and to pay it into a bank account of the factor.

In all cases the client administers the sales ledger and enforces payment from debtors as agent for the factor; thus, this form of factoring is usually referred to as **agency factoring** or **agency discounting**. The purpose of the arrangement is purely for financing the trade credit requirements of the client's debtors and the notice to them to pay the factor is to improve the factor's security. The service provided is, therefore, no more than that obtained by means of invoice discounting, and it is sometimes referred as **disclosed invoice discounting**.

This system is used where the client's pattern of trade consists of a large number of small debtor accounts but where he does not meet the standards

of financial standing or administration required for consideration of an invoice discounting arrangement. However, although the foregoing is the usual nature of agency factoring, at least one leading factoring company provides this service on a non-recourse basis, subject to approval of debtor accounts. Another recently developed variant has been described as a halfway house between recourse and agency factoring. Under that arrangement the factor retains responsibility for the administration of the sales ledger but allows the client to carry out collection procedures<sup>2</sup>.

#### **4) Invoice discounting or confidential factoring**

For the clients who need finance for the trade credit requirements of their debtors but no administrative service or protection, another service is provided extensively by factors.

By the simple expedient of releasing the client from the need to notify the debtors to pay direct to the factor and by providing that all debts sold to the factor should be subject to full recourse, factoring is changed to a purely financial service sometimes referred to as **confidential factoring** or, more commonly, **invoice discounting**.

In the early days of invoice discounting, debts represented by individual invoices were sold to factors. This system gave rise to some difficulties: it was not always possible for the client to pass on to the factor the payment for the invoice in its original form as the payment might be made after deductions for cross-claims or combined with payment of other invoices.

In recent years, the service of invoice discounting has more usually been provided on a *whole turnover* basis by including all the client's sales or all his sales to particular customers. The client maintains the sales ledger and collects from the debtors on behalf of the factor to whom the ownership of the debts has been transferred, and arrangements are made for the proceeds of collections to be paid by the client direct to the factor's bank account.

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<sup>2</sup> It is referred to as CHOC (Client Handles Own Collections), for a purist a misnomer: the collections are the factor's and not the client's because the debts belong to the factor!

### **5) Undisclosed factoring**

The term **undisclosed factoring** is sometimes applied to an invoice discounting as described above; but it is usually taken to denote an arrangement for invoice discounting whereby the factor will provide protection against bad debts to a limited extent by specifying that an agreed percentage (normally 80%) of any approved indebtedness shall be without recourse as regards credit risks.

The arrangement limits the protection to such a percentage so that the client, who maintains the ledger and collects from debtors, has some incentive to carry out the duties with efficiency. In some cases however factors have been known to accept the full amounts of approved debts should be without recourse and thus to provide the same protection against bad debts as in the full service.

### **6) Maturity factoring**

The above are the principal forms of factoring in which the factor provides finance by making prepayments of part of the purchase price of the debts purchased by him.

Where finance is not required, an arrangement, used increasingly by small businesses as an alternative to credit insurance, comprises full administration of the sales ledger, collection from debtors and protection against bad debts. This service, often called maturity factoring, can be defined as a full service factoring without the financing element.

Because of the lack of financing, the guarantees are different. The risk consists only in debtors' risk; there is no seller's risk. For the same reason, there are no financing commissions, the factor being remunerated through commission taxes.

- The factor pays his client's receivables in one of the following ways:

After a certain period from the date of invoicing (the maturity period); the client knows when he receives the money, so he can his cash flow accordingly, or

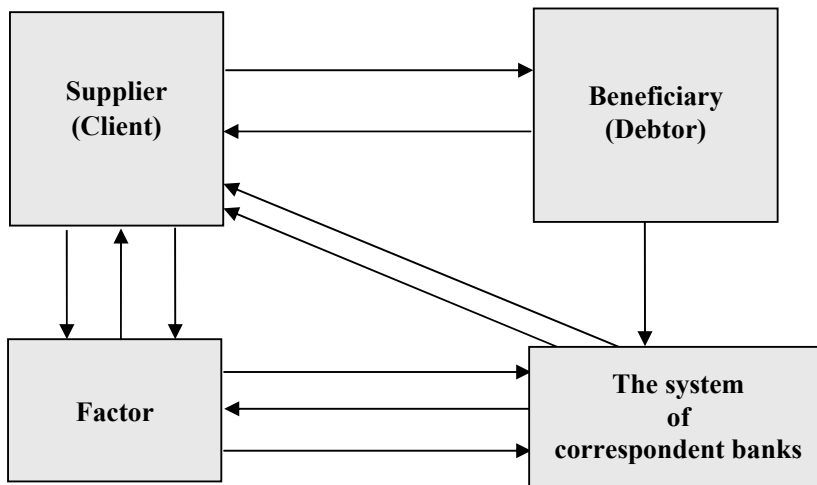
- Cashing in the receivables from the debtor, or

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- In the case of the debtor's insolvency, after cashing the insurance policy, if the non-payment risk is insured.
- To apply for this service, the client is supposed to have enough finance sources; he demands the factor to improve the weak administration of his organisation, to diminish the indirect costs and to ensure security.

Basically, a factoring operation involves three participants: **the factor**, usually a banking institution buying the receivables which a business, called **the client**, has over another business, called **the debtor**. The factor represents the link between the client and the buyer, to whom it renders several services.

#### *The mechanism*



Source: Cirstea, A., *Consortiile bancare si factoringul – certitudini ale cooperarii financiar-bancare internationale*, Bucuresti, 1999

1. The supplier (client) delivers the merchandises to his domestic or foreign client (debtor), according to the commercial contract concluded between them.

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2. On the basis of the factoring contract, the client presents to the factoring company a register consisting of :
  - the ceded receivables, together with their rights and accessories;
  - a declaration of transferring his receivables to the factor;
  - a payment request for the issued invoices.
3. After analyzing the invoices received from the client, the factoring company lets him know about the accepted invoices (taking into consideration the guarantees each of them provides).
4. The client sends to the factor the originals of the accepted invoices. From this moment on, it is the factor that will cash them in, and will take the potential financial risks that could appear. In his position as owner of the receivables, the factor has no right to turn against his client.
5. The client announces to his debtor the ownership transfer of his receivables to the factoring company.
6. The factoring company pays a first share of the accepted invoices' amount, usually 80 - 85% of their total value, after deducing the agio (the factoring company's commission).

The agio differs from one country to another and from one period to another, according to the economic situation and to the relationship between demand and supply.

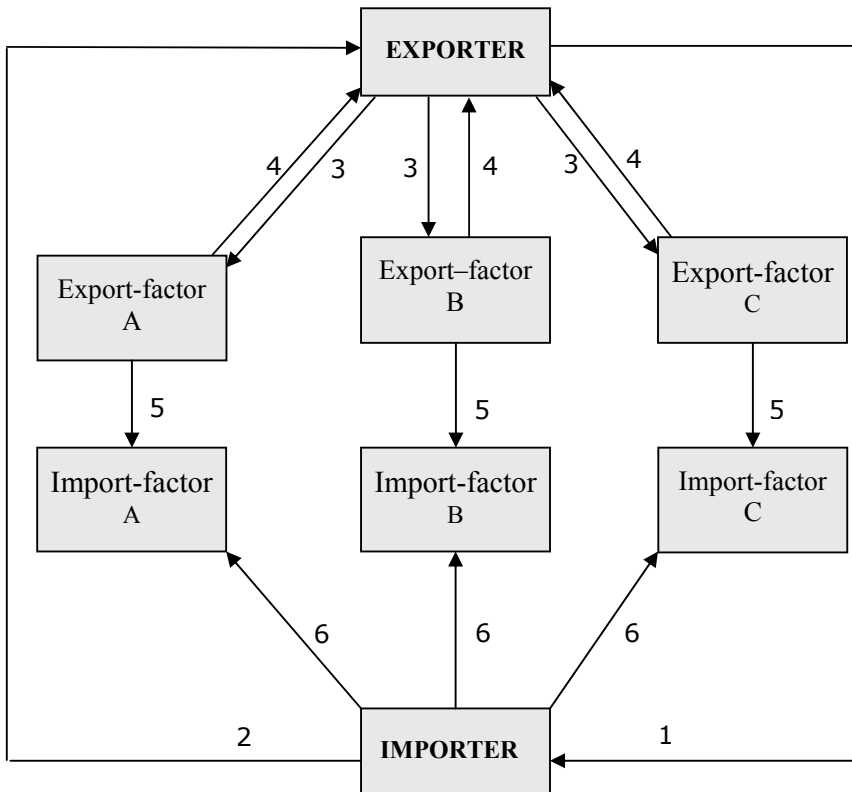
For its general services rendered to the client, the factoring company receives a commission, whereas for the prepayment of the invoices (before cashing them in from the buyer), it receives an interest, calculated as *pro rata temporis*.

7. The client learns from his bank (through a statement of account) about crediting his account by the corresponding amount.
8. Upon the received notification, the debtor will pay to the factoring company the entire value of the invoices on the maturity date stated in the economic contract.
9. The factor learns from his bank (through a statement account) about crediting his account by the total value of the accepted invoices.
10. Within 2-3 working days since it has cashed in the money from the debtor, the factor shall pay to the client the rest of 15-20%.

11. The client learns from his bank (through a statement account) about crediting his account by the value of the second share of the invoice value.

In a more detailed scheme, in the case of international contracts, besides the initial factor there is a second factor (resident in a foreign country), who will be an import-factor, if he takes the risks of collecting the receivables in his country, or an export-factor, if after buying the receivables of a domestic client, he will send them to be collected by a factor in the country of the debtor, thus exporting the risk.

The operational scheme<sup>3</sup> for this case looks like the following:



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<sup>3</sup> Source: Cirstea, A., *Consoțiile bancare și factoringul – certitudini ale cooperării financiar-bancare internaționale*, București, 1999

So, at international level, there are new participants coming up:

- **The import-factor:** a factor operating in the importing country, who takes the obligation, together with the debtor, of repaying the merchandises;
- **The export-factor:** a factor operating in the exporting country, who has information upon exporters, for which he takes the responsibility of collecting receivables from their debtors;
- **The factoring chain:** the international network of factoring companies and their relational system (there are three big international factoring chains: International Factors, W.B. Heller, Factors Chain International, but every international banking group has created its own factoring department).

The inter-relations created among all these participants in a complex factoring operation (at international level) function as follows:

1. The exporter delivers the goods or renders the services.
2. As a result of the export operation, payables are issued upon the importer and receivables are to be collected by the exporter.
3. The exporter cedes the rights (receivables) he has over the importer to a factoring company.
4. The export-factor pays on instant 85% of the invoice value to the exporter (called also seller or client).
5. Before making the payment, the export-factor keeps the interest (which it charges for prepayment) and then it cedes the paid receivables, together with an agreed share of interest to the import-factor.
6. The import-factor cashes in the invoice value from the importer. At this moment, the difference of 15% and the commissions between the import-factor, the export-factor and the client are also paid. The risk of insolvency is thus transferred from the client towards the export-factor, and from the export-factor towards the import-factor.

This technique provides the client with money available before the maturity of credits granted to importers.

If the factor lent his liquidities by a common credit contract, he would gain only the interest; moreover, he would have only the quality of a simple creditor in case the debtor goes bankrupt. Through factoring, instead, he

may charge an interest by 1.5-3% higher, included in the commission (for all the services offered). At the same time, by assuming the client's position towards the ceded debtors, the factor will benefit of all the guarantees the client used to have<sup>4</sup>.

Companies ask for factoring in order to benefit from various advantages, such as:

- The factor takes the risk of non-payment by the external debtors and makes the payment of the receivables before their maturity, turning a 'period-payment' into a 'current-payment';
- The period for obtaining liquidities is much shorter than in the case of a credit; the client will improve his cash-flow, the money being used according to his immediate needs and not for specific destination, as in the case of a credit.

The documents needed for obtaining financing through factoring are not as many as when applying for a credit. The acceptance of receivables by the bank is irrevocable, but it implies a proper execution of the commercial contract by the client.

The import-factor can check each of the buyers from various countries where the seller exports.

The debtor (importer) pays the value of the receivables in his country, avoiding a currency exchange; at the same time, he has the opportunity of corresponding with the import-factor in his own language and of solving potential litigations within the legal framework and the jurisdictional competence which are familiar to him.

The factoring operations represents an advantageous means of financing for exporters, providing liquidities necessary to develop their business, protection against the risk of non-payment by their debtors, administration and collection of invoices, in the conditions of attractive costs.

Taking into consideration that not all activities can be performed by factoring, the clients' selection supposes an analysis of the business, a deep understanding of all the aspects involved in it, in order to make the decision whether factoring is appropriate or not.

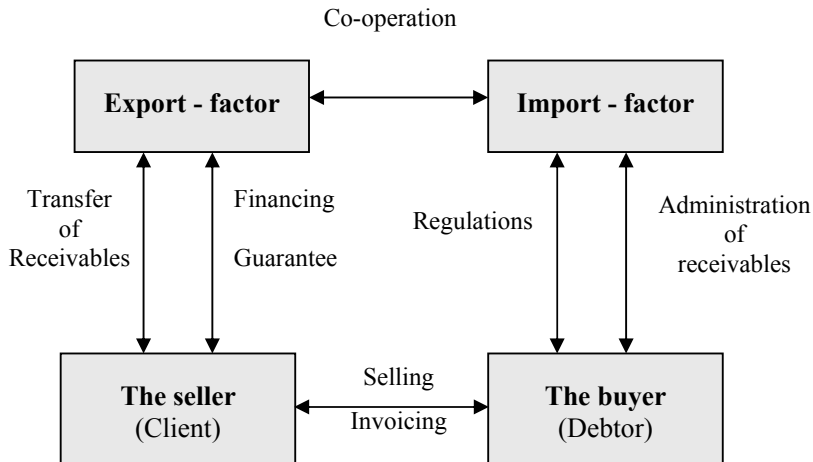
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<sup>4</sup> Popa I. (coord.), *Tranzacții comerciale internaționale*, Ed. Economică, București, 1997

Besides his obligation of cashing in receivables, the factor (both export and import) can offer his client two supplementary services:

1. **guarantee** for a proper execution of the contract;
2. **financing**, by making available the whole sum or a part of it, representing the invoice value, before the buyer's payment.

The relationship between the client and the factor, including all the three services provided (administration, guarantee and financing of receivables) can be summarized by the following scheme:



Source: Cirstea, A., Consortiile bancare si factoringul – certitudini ale cooperarii financiar-bancare internationale, Bucuresti, 1999

The relationships between partners give rise to certain bilateral obligations: seller – buyer, export-factor – client, import-factor – debtor, export-factor – import-factor.

**a) The relationship seller – buyer**

The seller has to deliver the goods. The order from the buyer (previously accepted by the seller) creates a certain and due receivable over the buyer. On the other hand, the buyer becomes a debtor who is obliged to pay the amount stipulated by the contract for the goods delivered by the seller.

**b) *The relationship export-factor – client***

The client agrees with the factoring contract proposed by the factor. This contract defines the rights and duties of each party.

The client has the obligation to transfer the receivables. In return, he may benefit from the three basic services: administration, guarantee and financing of his receivables.

As for the factor, he takes over the receivables presented by the client, but receives remuneration for the services he renders.

**c) *The relationship import-factor – debtor***

The buyer is the debtor, and he will be notified about his obligation to pay the value of the goods he bought directly to the factor.

**d) *The relationship import-factor – export-factor***

The co-operation relationship between the financial institutions which intermediate such an operation (this mechanism could not be possible without them) is achieved on contractual basis, being strictly regulated.

**6.3 The legal framework of factoring**

A factoring contract is the contract by which a person (the client) cedes his receivables to a third party (the factor), who assumes the responsibility of taking over the receivables in exchange for a tax (the agio).

The direct transfer of invoices (no other formality needed) does ceding the receivables, the factor becoming their owner.

The contract clearly and completely stipulates the rights and duties of each party.

***The nature of the contract***

The factoring contract has to comply with the common law regulations and it has an *intuit personae* character. This dimension is permanently present due to its commercial operationally. Thus, the factor may cancel the contract if significant changes in the financial or juridical structure of the client occur.

The contract stipulates mutual rights duties with onerous title (as their meaning is the payment for the services rendered by the factor to his client), whose execution is consequent, according to the time distribution of the operations' phases.

***The structure of the contract***

The structure of the contract (see the Annex No. 1) comprises two aspects:

- general conditions (regulating the general framework of the relationship between the factor and the client);
- Particular conditions (specific provisions agreed by the parties).

The general conditions refer to:

1. the factor's duties;
2. the client's duties;
3. the conditions of the guarantee provided to the client:
  - previous agreement regarding the list of debtors and the amount of their payables;
  - at any moment, the factor may modify the guarantees (only applicable to future operations);
  - the factor becomes the owner of the ceded receivables;
  - the receivables are not contested by the debtor;
  - the guarantee does not apply over receivables not cashed in either because of fortuitous causes (war, calamities), or as an effect of financial regulations regarding the currency transfer;
4. the average period of the credit (generally, it is periodically revised);
5. the payment of the accepted receivables;
6. the subrogation (setting the conditions to achieve it);
7. the cashing in of receivables (the client shall mention on his invoices that the payment is directed towards the factor);
8. the supervision of receivables:
  - the client's obligation to pass to the factor all the receivables regarding the agreed debtors;
  - the factor's right to agree or to reject the renewals or the arrangements requested by the debtors;
  - the expenses related to the cash in operations are made by the factor (for all the accepted receivables);

9. the remuneration of the factor:
  - *the factoring general commission*, calculated on the total value of the invoice;
  - *the interest* (a special commission) charged for crediting the client;
  - the client's obligation to pay all *the fiscal charges* related to the execution of the contract;
10. the indivisibility of invoices and compensations;
11. the right of control for the factoring company (or a third party appointed by it) over the documents regarding the contractual operations, as well as the obligation of the client to facilitate to the factor the exercise of this right;
12. The way of solving the contests, by stating the competent body.

The particular conditions include all the specific dispositions or derogations agreed by the parties, such as:

1. the operations for which the contract is applicable;
2. the good being the object of the contract;
3. the countries to which the contract refers;
4. the maximum amount guaranteed by the factor for each debtor;
5. the average period of the credits and the revision period;
6. the maximum period for each credit;
7. the maximum payment the factor agrees to make for crediting the client;
8. guarantees and other accessories;
9. the specific conditions for the factor's remuneration;
10. the duration of the contract, which is usually undetermined, and can be cancelled by either of the parties (a notice must be made three months before);
11. the authorized risks.

A factoring contract represents:

- ***A current account convention*** intended to record all the financial flows linked with the contractual operations.
- ***A payment effect*** determined by the transfer of the ownership right.

In case of non-payment at maturity, the factor may choose one of the following options:

- a) to cancel the crediting operation of the particular account and to debit the same account by the corresponding amount, or
  - b) To cancel the crediting of the account and to sue the debtors, in order to get his money back.
    - ***A guarantee effect***, because the receivables guarantee the debts of every party.
    - ***An innovating effect***, because the original receivable turns into an item of the new account, and from this moment on, all its specific actions, exceptions and guarantees end. By the effect of current account contract, the buyer does not pay the price, but places it in the credit part of the current account. Since the moment the receivable is included in this account, the seller cannot reject the sale-purchase contract anymore, because the receivable still exists only as an item of the account. Though, in case of nullity or partial cancellation of the receivable, this will affect also the recordings of the item in the account.
    - ***An indivisibility effect (compensation effect)***, meaning that since they're entering in the account, the receivables depersonalizes. This effect occurs only for one current account, not for two or more accounts, even if opened between the same parties (unless the explicit merger of the accounts).
- ***A convention of exclusivity***, according to which the client commits himself to deliver to only one factor the totality of the receivables he has upon all the debtors included into the contract.

### ***The factor's attributions***

According to contractual provisions, and due to the fact that he substitutes the supplier, the factor commits himself to the followings (concerning the particular field of his client's activity):

1. the duty to cash in the receivables;

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2. the financial risks derived from the commercial relationships between the client and the debtor;
3. updated information collection regarding the financial status of the debtor;
4. determination of the credit limit for each debtor (the client is notified about it);
5. guarantee of the receivables (together with the client) up to the established limits;
6. acceptance of the receivables for the goods included into the contract;
7. taking the position of beneficiary of the receivables;
8. performance of several operations (on the basis of the documentation), among which:
  - checking the primary financial statements;
  - accepting the documents related to the merchandises included into the contract;
  - debiting the client's account on the receivables' maturity date;
9. payment of the receivables' value (immediately after receiving the invoices and the docket), thus becoming the client's creditor;
10. calculation of the factoring commission and interest, deducing these amounts from the total value of receivables;
11. cashing in the invoices, keeping the necessary evidences of the debtors;
12. sending to the client periodic accounting evaluations of the debtors;
13. Starting a lawsuit against bad debtors (in case of non-payment of an invoice).

### *The client's attributions*

Mainly, the responsibilities of the client in a factoring operation (within his relationship with the factor or the debtor) are the following:

1. Guarantee of the receivables (together with the factor), up to the limits communicated by the factor and accepted by both parties;
2. Accepting responsibility in cases of technical or commercial contest forwarded by a debtor and admitted as valid;

### ***Short-term Finance Exports***

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3. Release from the concerns related to the debtors, all their financial operations being taken over by the factor;
4. duty to send to the factoring company at the dates agreed in the contract:
  - the invoices issued for his debtors in that particular period;
  - any other financial documents created in regard to the debtors;
5. maintenance of responsibilities for operations beyond the guarantee (going over the limits agreed with the factor), or for debtors not comprised within the factoring contract;
6. cashing in the value of the receivables ceded to the factor (since the moment the invoices and the docket are sent), less the factor's commission and the interest for the sum credited by the factor;
7. periodic reports regarding the situation of his debtors, sent by the factor;
8. notification from the factor about the commercial causes determining the non-payment of an invoice.

### ***Criteria for choosing factoring***

The classic criteria for choosing a factoring operation are the following two:

1. The turnover is sufficiently high, or else the factoring company would not have a yield high enough to cover the amortization of logistics and the risk division.
2. The average invoice value is high enough, because the unit cost of factoring services is usually higher than the established figures.

The other eligibility conditions are more or less negotiable and particular to each factor.

### ***Company needs***

The company applying for factoring has to determine its needs not only according to its present situation, but also according to its expected future

evolution: the turnover increase produces structural consequences at various levels.

#### **6.4 Advantages and disadvantages of factoring**

##### ***The main advantages provided through factoring are:***

The greatest advantage of international factoring consists in the exporter's contact with only the factor resident in his country; thus, the exporter has an easy and effective way of tracking, recording and cashing his receivables from debtors in different countries. The export-factor is in charge with the international operations, the client having just a domestic and easy-to-conduct transaction to conclude.

At first, factoring has been a technique preferred by small and medium size companies, but larger companies discovered, at their turn, the flexibility of receivables financing. The main benefits for the users of factoring services are: a consistent cash flow, lower administrative costs, reduced credit risks, more time for core activities.

Factoring also provides complementary advantages for the clients, such as:

1. no administrative operations of tracking and cashing in the invoices and other receivables from the debtors;
2. a more efficient use of the financial resources, being able to make use of the funds received from the factor on account of the ceded invoices;
3. reducing the funds for the current activities;
4. the opportunity to start business relations with a larger number of clients (debtors);
5. improved security, by better knowing the debtors' standing;
6. the enlargement of the market, by establishing relations with worthy partners;
7. no preliminary operations and expenses before concluding international commercial contracts, in order to find out the financial status of the partners, this being the factor's duty;
8. exemption from legal actions in the case of debtor's non-compliance with the contract terms;

9. all the accounts concerning the relations with debtors are replaced by only one account in order to record the operations done by the factor.

For the factor, the advantages can be summarized by the following:

1. He knows all the details about the client's debtors, so he does not start business with partners having low credit worthiness;
2. He can find new clients with a high standing within the international factoring network.

***The main difficulties and limitations in factoring are:***

The use of a factor improves the cash flow and helps avoid over-trading, as well as reducing overheads by allowing someone else to take responsibility for debt collection.

However, many firms are resistant to factoring, because it is often argued that recourse to a factor is a sign that the firm is experiencing trading problems. If this were the case, then that firm's suppliers might lose their own trade credit arrangements and be required to pay invoices in advance of receipt of the goods and services involved.

Furthermore, where firms experience delays in payments of more than a specified number of days, the factor will reclaim the funding already issued.

Finally, firms may find that, once they rely upon the services of a factor, they may be 'locked in' to the relationship even when conditions improve, because of the cash flow implications of any arrangements<sup>5</sup>.

The auxiliary downsides refer to:

1. The relatively high costs (the interest and the commission);
2. The difficulties raised by the termination of factoring relations:
  - for the client, because he has no experience in book-keeping for debtors who have been used to work with the factor;
  - for the factor, because he loses a client, diminishing his profits;

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<sup>5</sup> Burns, P., Dewhurst, J., *Small Business and Entrepreneurship* (2<sup>nd</sup> edition), Macmillan Business, Hampshire, 1996

3. The low autonomy of the client, because the factor knows in detail all his administration and his relations with debtors.

## **6.5 The factoring services in Romania**

The development of factoring practices in Romania is not such a common technique. This can be explained by the lack of specialized institutions of this kind. At the same time, the banking institutions which are allowed by law to perform such activities, have not yet developed an efficient and comprehensive cooperation system with factors in other countries (either specialized institutions, commercial banks or their specialized departments), in order to be able to check the creditworthiness of various foreign debtors, and also to cash in directly their receivables.

### ***The first steps***

The factoring system entered Romania in 1994, when the Romanian Bank for Development joined the Factors Chain International. It was the first Romanian banking institution starting offering this kind of services on the Romanian market. The offer of the Romanian Bank for Development at the time was addressed exclusively to Romanian exporters, and the bank has been providing only export-factoring services so far.

In October 1999, the Romanian Commercial Bank and the Demirbank joined the Factors Chain International at the same time. In the beginning, the Romanian Commercial Bank's offer was directed only to exporters through export-factoring services. After one year, though, the bank started performing factoring operations also for domestic customers (in ROL).

The customers of factoring have diversified and increased significantly every year. The total value of such operations in the last year was USD 11 mill., the Romanian Commercial Bank earning USD 300,000 out of this amount.

There are a big number of medium and small size companies from the textile and furniture industry, which have required and used factoring services. Well-known companies in chemical and petrochemical industry have also asked for these services, giving up other kinds of financing for factoring.

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In the present state of the national economy, the factoring represents a viable solution for Romanian exporters. It will promote and encourage exports from Romania, by providing:

- *Resources* to cover the immediate liquidity needs,
- *Guarantee* (by the factor) for cashing in all the receivables, and
- *Risk taking* in case of non-payment of foreign debtors.

### ***The legal provisions***

In legal terms, the factoring services for Romania were regulated through the Emergency Government Ordinance no.10/1997 (issued on April 19, 1997, in order to stop the financial blockage and the loss in the economy).

According to this law, factoring is seen as one of the financial instruments allowed for payment between commercial companies or between these companies and autonomous Regies. The authorized legislative body defined it as a contract concluded between *the client*, who sells goods or renders services, on one side, and *the factor*, which is a bank or a specialized financial institution, on the other side. Through this contract, the factor provides financing, receivables tracking and credits risk protection, whereas the client cedes (by sale or subrogation) his receivables arisen from goods sold or services rendered to third parties.

On September 2, 1997, the government issued methodological norms for the implementation of the provisions of the ordinance. Within these norms, it is stipulated for factoring that the value of receivables ceded by the client through the contract will be negotiated by the parties and it needs the approval of the client's Board of Directors or manager, as it is the case.



### Progress test

1. Define short-term finance.
2. Show the difference between post-shipment and pre-shipment finance.
3. Define the factoring.

4. List and define the main types of the factoring.
5. What is the recourse factoring?
6. What are the parties involved in the mechanism of the factoring?
7. Describe the mechanism of the factoring.
8. What are the participants of the factoring at international level?  
Describe the mechanism.
9. What are the main elements of a factoring contract?
10. List the factor's attributions under the contractual provisions.
11. List the client's attributions under the contractual provisions.
12. List the advantages provided through the factoring, as well as the difficulties and limitations in factoring.
13. Describe the factoring in Romania.

## FACTORING AGREEMENT

**The Romanian Commercial Bank** registered in the Register of Trade under the no. J/12/.../1990, located in Bucharest, 110 Bd. Ferdinand, hereby called *the Factor*, represented by Mr..., as general manager,

And

**S.C. "X" SRL**, phone/fax ....., having its headquarters in Bucharest, 22 Negura Street, registered in the Register of Trade under the no. J38/.../1991, hereby called *the Client*, represented by Mr..., general administrator,

Have agreed upon the following:

1. The Client cedes, in favor of the Factor, its receivables emerging from the contract no. 05/2001, concluded on March 19, 2001, with S.C. "Y" S.A (see the Annex No. 2).
2. The Factor accepts the ceded receivables from its Client, amounted to EUR 22,500. Since this moment on, the Factor becomes the new owner of the receivables, so it will cash them in from the debtor.

If within 30 days from the moment the Factor is informed about the debtor's inability to pay the due amounts of principal and interest, the debtor is still not able to pay these amounts plus penalties, the Factor is allowed to claim to the Client to make the payment.

3. This agreement is concluded for a period of 2 months, with an interest rate of 17% charged by the Factor on the day of the agreement.
4. The Client is allowed to receive immediately from the Factor the amount of EUR 18,000, representing 80% of the total value of ceded receivables, under the following conditions:
  - A) The sum has a compulsory destination: it shall be used only for matters linked with the performance of the mentioned contract.

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B) The Client accepts to pay monthly the principal and the interest, as charged by the Factor, for the advance payment received. The schedule of repayment is presented in the table below:

<b>DATE</b>	<b>PRINCIPAL</b>	<b>INTEREST</b>	<b>TOTAL AMOUNT</b>
23-Apr-01	9,000	3,060	12,060
23-May-01	9,000	1,530	10,530
<b>TOTAL</b>	<b>18,000</b>	<b>4,590</b>	<b>22,590</b>

The repayment is allowed to be pre-paid, partially or entirely. If the client pays the whole amount before the due date, the provisions of the present factoring agreement become void and after this moment both parties will be exonerated from subsequent obligations regarding these provisions.

Any infringement of the payment terms entitles the Factor to cancel the payments to the Client, unconditionally, and to claim potential damages.

The payment will be made in the Client's account, no. 4391.1-...1 and will be available starting March 23, 2001.

During the period of the agreement, the Factor is allowed to adjust the interest rate in accordance with the evolution of inflation and cost of financial resources. The new interest rate will be applied to the outstanding principal on the day the change has occurred and the Client will be informed within 5 days, with no other specifications. In the case the Client does not pay the rest of the principal and interest within 10 days after notification, the new interest level is considered as accepted by the Factor.

The interest and bank commissions are computed and paid monthly, starting one month after the factoring agreement enters into force. Interest computation period is since the 23<sup>rd</sup> of the previous month till the 22<sup>nd</sup> of the current month.

The Client is obliged to:

- A) Employ the money only to the specified destination;
- B) Pay the principal, interest and commissions on their maturity, as agreed;
- C) Submit any document requested by the Factor, issued from its relationship with the debtor.

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The Factor is entitled to cancel the present agreement if the Client submits any false information.

The Factor's obligations are:

- A) Payment of the accepted receivables' value immediately after submission of invoices by the Client;
- B) Calculation of factoring commission and interest;

Providing periodic evaluations to the Client on the receivables' cashing in situation.

The present factoring agreement has been concluded today, March 22, 2001, in 4 copies.

**FACTOR:**  
*Romanian Commercial Bank*

**CLIENT:**  
*S.C. "X" SRL*

**CONTRACT NO. 05/2001**  
**Concluded on March 19, 2001**

**Art.1 Contracting parties**

*S.C. "X" SRL*, phone/fax ....., having its headquarters in *City., 22 Negura Street, sector 2*, fiscal code *R .....*, account no. *4391.1-...1/ROL*, opened with *the Romanian Commercial Bank Bucharest* –, represented by *Mr. ..* and *Mr. ...* – administrators, as the **Performer**,

And

*S.C. "Y" S.A.*, phone ....., having its headquarters in *Town, 17 Avram Iancu Street*, fiscal code *R .....*, account no. *5221100000..*, opened with *the Transilvania Bank –Branch*, represented by *Mr. ..* - manager and *Mr. ..* – administrator, as the **Beneficiary**.

**Art. 2 Object of the contract**

Automation equipment for the production line of concrete-based mortars.

**Art. 3 Phases and execution deadlines**

The phases and execution deadlines according to the annex 1.

**Art. 4 Values and terms of the contract**

The value of the contract, according to the annex 1, is EUR 20,000 (VAT not included) and refers to the phases specified in the annex 1. The value and completion deadline for each phase has been specified in the annex 1.

The payment shall be made in ROL, for the exchange rate ROL/EUR calculated by the National Bank of Romania on the day of the payment.

The projection phases (the execution project and the information program for the programmable equipment and for the operation station) will be paid after the presentation of the minutes.

**Art. 5 Payment terms**

5.1 The payment for the activities performed by the Performer shall be made by the transfer of agreed amounts through the parties' banks, according to the commercial invoices.

- 5.2 The payment of the invoices issued by the Performer shall be made according to the documents certifying the completion of the works performed by them, which have been accepted by the Beneficiary.
- 5.3 The checking of the works by the Beneficiary should be made within 5 days after their reception and the payment of the invoices, within 15 days from their acceptance.
- 5.4 If a work is not has not been checked by the Beneficiary within the 5 days, it is considered accepted, so the corresponding invoice will become payable.

#### **Art.6 Obligations of the parties**

6.1. The obligations of the Performer:

- to perform the works included in the contract, according to the technical specifications;
- to perform quality works, on the deadlines stipulated in the contract;
- to operate the necessary modifications in the case the initial technical documentation has been changed, and at the same time, to renegotiate the terms and values;
- to remake, out of its own resources, the poor quality works due to its fault, found during the execution and /or while the checking.

6.2 The obligations of the Beneficiary:

- to provide a clean working place as the works advance;
- To perform its own works, according to the technical specifications.

#### **Art.7 Projection deadline**

The Performer commits itself to finishing the projection phase until April 23, 2001, under the condition of being provided the projection theme by the Beneficiary until March 20, 2001.

#### **Art.8 Guarantees**

The performed works are guaranteed 12 months after reception, but no more than 18 months after delivery.

## **Art.9 Contractual clauses**

9.1 The Beneficiary may cancel the contract if:

- the Performer goes bankrupt, declares bankruptcy or starts liquidation;
- the Performer has abandoned the contract.

In the case of termination of the contract because of the Performer, the parties will assess the stage of the works already performed, the inventory of the auxiliary equipment and tools, and will establish the amounts to be paid according to the contract.

9.2 The Performer may cancel the contract if:

- the Beneficiary neglects its obligations, making the Performer unable to perform its activity;
- the Beneficiary has not made a payment fallen due, according to the terms of the contract;
- the Beneficiary goes bankrupt, declares bankruptcy or starts liquidation.

## **Art.10 Penalties**

10.1 The non-payment of an invoice within 20 days after their issuance makes the Beneficiary liable for a penalty of 0.15%/day, but less than 5% of the invoice value, and leads to the postponement of the next payments with the number of days of this payment delay.

10.2 The delay in completion of works by the Performer will be charged with a penalty of 0.15% on the value of the phase, but less than 5% of the phase value. As a guarantee for the proper completion, the Beneficiary retains 5% of the value of works until the reception of the last phase.

## **Art.11 Final dispositions**

Any modification or addition to this contract is possible only through additional acts signed by both parties.

Before canceling the contract, the parties will try to reconcile, and the results of this action will be recorded in a minute.

For the unsolved litigation, the parties may address to the Court, in the conditions of the Romanian laws, in order to materialize the requested claims.

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None of the parties will be held responsible in the case of force majeure, according to the Romanian law.

A protocol containing the work safety rules will be concluded and annexed to this contract.

This contract enters into force in the moment of its conclusion by the parties and after the Beneficiary has paid an advance of 35% of the total value of the contract.

This contract has been concluded in 2 copies, one for each party.

Date: ***March 19, 2001***

**BENEFICIARY:**

**PERFORMER:**

Administrator,

Manager,

Administrators,

**ANNEX 1  
To the Contract no. 05/2001**

<b>No.</b>	<b>Name</b>	<b>Phase</b>	<b>Value (EUR)</b>	<b>Deadline</b>
1	Art.2	Execution project, information program for the programmable equipment and for the operation station	7000	5 weeks from conclusion and advance payment
2	Art.2	Programmable equipment and PC with microprocessor INTEL and display 19"	13000	5 weeks from conclusion and advance payment
3	Art.2	Command board		5 weeks from conclusion and advance payment
<b>TOTAL</b>			<b>20000</b>	